Narnolia®

INVESTMENT PERSPECTIVE

Nov. 2022

IMPACT OF GLOBAL RE-SET IN INTEREST RATES

Shailendra Kumar
Chief Investment Officer
Narnolia

Dismal performance of equities across globe during calendar year 2022 has been attributed to rising interest rate and geo-political conflict. Among various macro factors, interest rate has the highest impact on how financial market performs particularly in the short term. Prevailing interest rate dictates fund flows to various asset classes impacting their performances. In the long run equity performances are more about earnings growth, short term movement is more on the account of changes in valuation multiple and on a fundamental basis interest rate is key to where valuation multiple be for equities.

Interest rate movement especially in US is the pivot point for all major economies' valuation multiple as the country's FED rate impacts rates and hence allocation of fund flows globally. Question currently in every market participant's mind is as to what will be the terminal interest rate, or at what rate the interest rate will peak and start coming down. A closer look at how the current rate raise cycle is unfolding suggests that we need to look at current situation as a larger regime shift thereby taking a longer term view on interest rates, flows and equity valuation multiples.

What Makes us Take a Bigger Perspective?

Here is a chart of various rate hike cycles in US over the period of last 40 years. For the last 40 years whenever interest rate was rising, the question always was how far the rate raise cycle will last. And it was a very legitimate question, as in a structural sense, rate was in a secular falling trajectory. US 10 year bond yield in US in 1982 was 15%+ (yes, in US 40 years back interest rate was 15%+) but kept falling in a structural sense to 0.5% during 2020.

40 years chart of US 10 year Government bond Yield
(Depicting a falling trend; that after every rise, the interest rates have consequently fallen)

So now during 2022 when rate are rising, the question among analysts and economists again are that how far the rate rise cycle will go (as it is mentally understood looking at last 40 year trends that after a short rise, interest rates have only fallen thereafter). But is that the right question?

Look at the speed in which the rate rise has happened recently. In the last 6 months, rate has risen by 275 bps (2.75%). Is something unusual here?

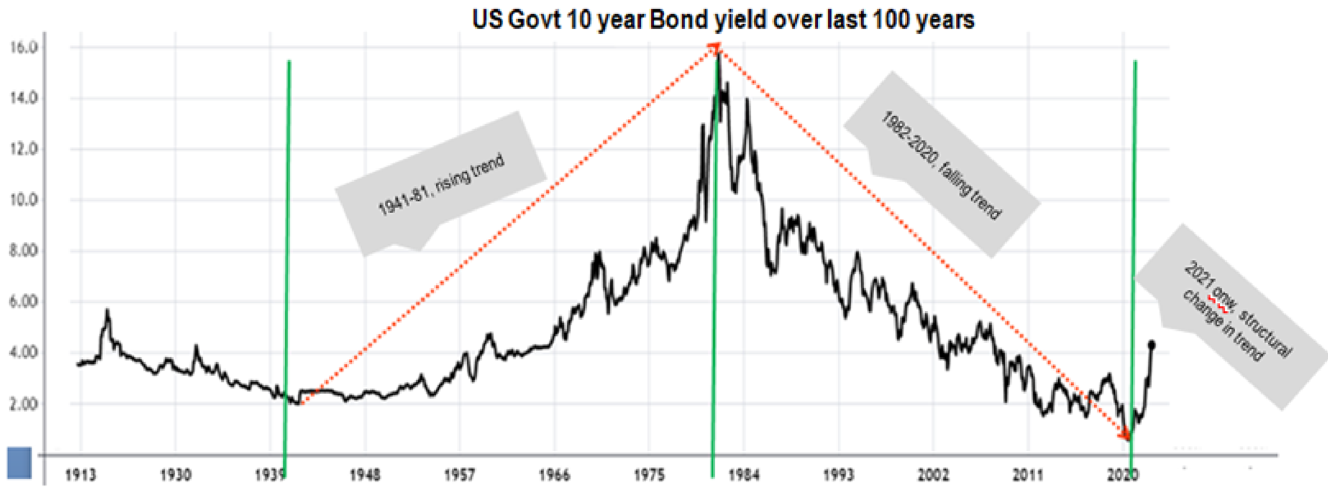
Period of Rate hikes	US Fed Rate	Rate rise cycle (in months)	Rise in first 6 months
Mar-88- May 89	6.75%-9.81%	~14	1.37%
Feb-94- Feb 95	3.25%- 6.00%	~12	1.50%
Jun 99- May 00	5.00%- 6.50%	~10.5	0.50%
Jun 04- Jun 06	1.25%-5.25%	~24	1.00%
Oct 15 – Dec 18	0.25%-2.50%	~38	0.25%
Mar 22 onwards	0.50%-3.25%	~6	2.75%

In previous rate cycles since '88, interest rate hike has been a maximum of 1.5% in first 6 months. For eg, during 1988-89, the total hike was 3.06% within a span of ~14 months, and in the initial 6 months, the hike was only to the extent of 1.37%. Similarly, in '94-95 rate hike cycle, the hike in the initial 6 months was to the tune of 1.5% and so on. However, in the current rate cycle, in the last 6 months, the hike in interest rate has already crossed 2.75%. This pace of hike definitely signals that something very unusual is happening in the current rate cycle.Our belief is that the question of "terminal interest rate" needs to be reframed as we are looking for solutions from the last 40 years cycle and the answer to this question cannot be found by the recent 30-40 years trend.

We need to push ourselves for a bigger perspective. Look at a bigger rate chart say 100 yrs from 10 y bond yield perspective and this will enable us to frame our question properly.

Interest Rate Over Last 100 Years

Let's look at how the US 10 year Bond Yield behaved pre 1982 era. The bond yields kept rising since 1941 from levels of 2% to 15% till 1982



We Can Divide the Chart in Broad 2 Periods:

1. 1941-1980- where US government Bond Yield went up from sub 2% to higher than 15%
2. 1981-2020- where the yields fell all the way to 0.5%. This fall can again be seen in two parts-
    i. Pre 2008 - Falling interest rates which can be attributed to lower inflation due to globalization where manufacturing was getting shifted to lower cost geographies and;
    ii. Post 2008 - a more severe fall from 3% to close to 0% on the basis of huge liquidity infusion by central bankers.

In the last one year, policy stance has changed completely and consequent rise can be seen as a different cycle rather than a bounce back in the previous cycle. The 10 year US Government bond yield is close to ~4% which means we are back to the place where the artificial pumping by Central bankers had taken place. Also, the phase of globalization is fading and world is entering into a de-globalization phase (at least partly) when we are talking of China +1 , Europe +1 etc.

We need to understand that there is a structural regime shift in interest rate cycle that is in making. The world instead may be entering into a much deeper and structural high interest rate high inflation for a longer period, unless the policy makers take a complete U-turn oranother round of globalization starts happening.

*Our **base case** for US rates going forward is -Not necessarily a sharp rising trend but more like **an elevation and then long period of sideways movement***

Another notable shift is the rising influence of governments on economy, businesses and markets. What worries the government most in these difficult times is not recession but a fear of Depression, corporate default and consequent unemployment. Specially, post Covid-shock and current energy crisis in Europe there are wider consensus that government need to be the key force behind helping businesses and households to stay afloat. Recent examples of government guarantees of private debt suggest the same.

What Changes this New Regime will Bring Out?

Statistically, last 100 years' period of rising interest rate has coincided with falling govt. debt to GDP. Government Debt to GDP at 137% currently is a serious matter of concern. As Nominal GDP keeps rising and Debt figures remian in control with more debt in the form of guarantees to important sectors (Note that guarantees are contingent liabilities and will not form part of FED's Balance Sheet), Debt to GDP figures will start showing a downward trend. This is similar to what happend during 1942 - 82 period.

Currently, US Debt to GDP has risen to 137.2%

- Another important aspect is that current high inflation is not because of high demand but because of supply constraints and this is here to stay keeping interest rates high. For eg, recently as Crude prices fell, OPEC announced a cut in production; thus, giving support to prices again.

- This higher level of interest rate will also influence how funds flow to various asset classes. Globally across mutual funds AUM of 59 trillion dollar, 44% money is into equities and 20% into debt. Going forward incremental inflows will be more attracted towards debt instruments and percentage allocation to debt will rise. Our base case is that this will be orderly and more pronounced on incremental inflows.

» There will be impact on bond yields across the world. Our base case for US 10-year for next decade is sideways movement at elevated levels of 3%-7%. Surely it will be higher than what the rates had been during previous decade. But the same may not be true for Indian bond Yield. Indian yield has stayed at 400 bps premium over US bond yield over last twenty years. This rate of premium will change going forward. In a macro construct basis, Indian bonds yield will behave the way Chinese bond yields have behaved over the last twenty years and Chinese 10-year bond yield spread over US had average 0 to 100bps. Consequently we expect Indian 10-year to trade at yield of 4%-8% for a long time. And that's a good news as currently the yield is already at 7.5% so going forward, we do not expect much of an impact on Indian equity valuation multiple due to rise in interest rate.

» There will be impact on valuation multiples of equities globally. During 1940-1980, average PE in US was 14X while during last 20 years it had been 20X. As interest rate settles at higher levels some de-rating in equity valuation multiple is bound to happen. However, India looks insulated here as 1) Earning growth trajectory looks more stable and 2) Indian interest rate does not have high upside.

Meanwhile amid all these global macro adjustments, Indian equity market continues its sideways journey that it is in since last one year. It's kind of a base building and longer term risk-reward remains favorable.

HAPPY INVESTING!

Shailendra Kumar
Chief Investment Officer
Narnolia

Narnolia Investment Advisors Private Ltd. (NARNOLIA) is a SEBI Registered Investment Advisors (Non Individual) having SEBI Registration Number INA300005439 (Permanent) , CIN:- U67120JH2007PTC012791Corporate Address: 803, Wing A, Kanakia Wall Street, Chakala, Andheri, Mumbai – 400093, PH: 022 6270 1200/ 022 6839 1200, Email Id: iap@narnolia.com. SEBI Regional office address: L&T Chambers, 3rd Floor, 16 Camac Street,
Kolkata – 700017

NARNOLIA is 100% subsidiary of Narnolia Capital Advisors Private Ltd. which is NBFC registered with RBI. Narnolia Capital Advisors Private Ltd is owned by Narnolia Securities under the Promotership of Mr. KrishnanandNarnolia. Details of associate entities are available on the website of the Company. Narnolia is not affiliated with any intermediaries for execution or distribution services and no consideration including any commission or referral fees is received directly or indirectly at group level for the said services. Client shall not be under any obligation to avail the execution/distribution or other services offered through any entity as recommended by NARNOLIA and no consideration is received for the same. There is no pending regulatory matter against NARNOLIA as on date.
No disciplinary action has been taken against the Company by any regulatory/statutory authority.
No complaint has been lodged by any client relating to our Investment Advisory Services.

Conflict of interest
Narnolia Financial Services Ltd., a company registered under the Companies Act, 1956, is a SEBI registered intermediary and offers services as Merchant Banker, Portfolio Manager, Research Analyst and also AMFI registered Mutual Fund distributor and is one of the affiliates/Associate Company of NARNOLIA. However, appropriate Chinese walls is maintained as required under SEBI Investment Advisor Regulation.

NARNOLIA FINANCIAL SERVICES LTD. is a SEBI REGISTERED PMS- INP000006420, CIN- U51909WB1995PLC072876. Registered office: Marble Arch, 2nd Floor, Office 201, 236B, A J C Bose Road, Kolkata 700 020,033 40501500; Corporate Office: 803, A wing, Kanakia Wall Street, Chakala, Andheri East, Mumbai - 400093, Maharashtra; PHONE NO.: +91 22 6270 1200.